Post-Workshop Comments of Constellation Energy Commodities Group, Inc. Constellation NewEnergy, Inc., and Mirant California LLC, Mirant Delta LLC, and Mirant Potrero LLC on Use of Portfolio Analysis in Electric Utility Resource Planning

California Energy Commission Docket No. 06-IEP-1M and 2007 IEPR - Portfolio Analysis

I. Introduction.

As permitted by the ***Notice of a Staff Workshop on Use of Portfolio Analysis in Electric Utility Resource Planning*** ("PA Workshop Notice") issued by the California Energy Commission ("CEC") on May 23, 2007, Constellation Energy Commodities Group, Inc. and Constellation NewEnergy, Inc.("Constellation") and Mirant California LLC, Mirant Delta LLC, and Mirant Potrero LLC("Mirant") (collectively, "Constellation and Mirant") submit these comments to the PA Workshop conducted on June 4, 2007.

Constellation and Mirant appreciate the CEC's concern stated in the PA Workshop Notice that "[a]lthough electric utility resource long-term planning utilizes risk assessment and scenario analyses, gas-fired resources continue to be added at levels that do not meaningfully reduce California's reliance on natural gas, resulting in long-term price and carbon risk." Furthermore, Constellation and Mirant agree that mechanisms like "the efficient frontier" portfolio analysis may be useful in informing investment decisions, but when that type of analysis is then translated into mandated utility investments—as has been done in the past with integrated utility resource planning—the analysis does little to minimize ratepayer risk because the full costs of those investment are borne by ratepayers once the portfolio is approved. Thus, even the most stringently applied portfolio analysis will, at best, potentially reduce the "wrong answers" that integrated resource planning

yields. In other words, so long as regulatory guarantees provide assurance of cost recovery for utility investment the risks borne by consumers of such investments will not be actively managed.

Constellation and Mirant believe that the best way to minimize ratepayer risk is to implement competitive market structures that support infrastructure investment by market participants who are able and willing to manage the risks of that investment across the range of market conditions that will occur. When these types of competitive market structures are in place, market participants and investors will develop portfolios that address reliability and environmental requirements without the direct intervention and regulatory guarantees that are necessary when the utilities alone manage infrastructure investment. In this way the ongoing risks of those investments are moved away from ratepayers.

The CEC is already an integral partner in the work that is ongoing at the California Public Utilities Commission ("CPUC") and the California Independent System Operator ("CAISO") to implement competitive market structures that are intended to ensure that market-based mechanisms will support much needed investment in energy infrastructure. Constellation and Mirant urge the CEC to ensure that the portfolio analysis mechanisms that it is investigating in this proceeding do not undermine those efforts.

II. A Return to Merchant Investment Mechanisms Will Do More To Minimize Ratepayer Risk Than Will Utility Integrated Resource Planning and Investment.

Currently, the utilities are required under law (AB 57) to provide procurement plans for CPUC review every two years. Since its implementation, the AB 57 procurement plan reviews have resulted in each of the IOUs presenting their proprietary needs

assessment for both bundled and unbundled customers. As a result of these plans, the utilities have been authorized to procure new generation. Some of this new generation is, or has been, procured under what is commonly referred to as the hybrid market structure that reflects a mix of traditional rate-based facilities and Power Purchase Agreements ("PPAs") with the developers of the facilities secured as a result of competitive RFOs. In addition, and separate from the AB 57 process, each of the utilities has been granted authority to pursue "unique fleeting opportunities" ("UFOs") for infrastructure investment outside the AB 57 procurement plans, many of which have arisen due to the financial difficulties of non-IOU generating companies. The efficacy of the hybrid market structure is currently being debated in the CPUC Long Term Procurement R.06-02-013 ("LTPP Proceeding"). The debate centers around the fact that the existing hybrid market structure, where investment through utility rate-based or long term PPAs backed by the utility regulatory guarantee, effectively precludes competitive markets from being able to support a third investment paradigm of merchant investment where the full life cycle costs and risks associated with new infrastructure investment are actively managed, rather than treated as a cost pass through to ratepayers. Attachment A to these comments contains testimony co-sponsored by Constellation and Mirant in the LTPP Proceeding that describes the flaws in the hybrid market structure. The testimony was summarized as follows:

> First, the current utility procurement model as implemented through the LTPP is incompatible with a competitive market model. The current LTPP approach is a classical central planning approach, involving long term rate funded commitments by utilities, either through rate base construction or PPAs that are backed by regulatory guarantees of cost recovery for the utilities. Even though new entry

will result from such a utility procurement process, it is not competitive entry. It is centrally planned and rate-funded, and significant financial risks are assumed by ratepayers when the requisite regulatory guarantees of cost recovery are provided to utilities. This has a chilling effect on merchant entry. Private developers will not be willing to put their own capital at risk to build new generation on a merchant basis while the Commission continues to pursue a utility resource planning process with regulatory guarantees for certain projects. Generation investments are risky propositions given the tremendous uncertainty in future fuels prices, load levels, technology costs, carbon control, and other environmental requirements. No private developers will take on such risks through merchant entry, nor will there be a natural transition to a true competitive market model, so long as utility planning and funding of new generation – directly or through contracts - remains the norm. Thus, the hybrid market, as it is implemented through the LTPP process is both a substitute for, as well as an impediment to, a true competitive market end state.

My second conclusion is that the competitive market model should remain the desired end state for California. Relying on markets to make investment decisions, rather than central planning backed by ratepayer guarantees, is good policy that will benefit consumers the most in the long run. California faces an ongoing need for new generation investment to serve growing load, replace its aging power plant fleet and to achieve its aggressive environmental objectives. Experience both in the electric sector and elsewhere in the economy suggests that these types of investment decisions are best left to the market, not made by entities using ratepayer money. Indeed, the results of central resource planning by utilities or regulators, with the market risks assumed by ratepayers, has been a series of planning decisions that turned out after the fact to be uneconomic. Whether these financial commitments were in the form of utility owned generation or long-term PPAs, they were undertaken on behalf of ratepayers and were eventually paid for by ratepayers. The end state competitive market model will support infrastructure investment without the backing of regulatory guarantees. Reliance on a well structured **competitive market** model will serve customers better in the long run.

Third, for the state to achieve the **competitive market** model end state that was articulated in D.06-07-029, the Commission must do more than develop the RAR and MRTU – it must deal with the inherent incompatibility between the two models and take steps now to modify the current LTPP process, lest the transition, and its

associated customer benefits, be unreasonably delayed. Three specific steps that would underscore the Commission's commitment to the competitive market end state are:

1. A requirement that LTPP procurements approved in this proceeding and any future interim LTPP procurements be premised on the applicable, Commission-approved RAR reserve planning criteria – not some separate set of planning assumptions developed by the utility.

2. Starting now, for any new generation commitment -- ratebased or PPA -- proposed by a utility, other than peaking resources necessary to reach the minimum RAR requirement, the sponsoring utility should be required to demonstrate that the resource meets stringent investment criteria that mimic market competition, in the form of either a shorter payback period or a higher discount rate than those that would typically be used by a utility when making a long term investment decision.

3. Starting now, for any utility competitive solicitation for new generation and any comparison among ratebased and PPA alternatives, there should be a requirement to use length of "guaranteed" cost recovery (assumed to be life of plant for proposed rate based investments) as one element of the evaluation. The utility should be required to ask developers to indicate in their bids the shortest contract length for which they would be willing to build a new plant in return for a PPA at a reasonable price. The length of the PPA required by the developer could then be used as a parameter in the evaluation of bids, so that the length of the guarantee that is requested by a developer could be used as a "tie breaker" to distinguish among projects with otherwise similar economics (other things being equal, shorter is better). For comparison purposes, ratebased alternatives would be deemed to implicitly require life of the unit guarantees.

These changes would not jeopardize reliability, but they would help to reduce the long term financial risks imposed on customers through the LTPP process and minimize the harmful impact on ongoing competitive market development. They would demonstrate the Commission's intent to transition to the competitive market end state at the earliest opportunity.[1]

[1] *Prepared Direct Testimony Of Michael Schnitzer On Behalf Of Constellation Energy Commodities Group, Inc., Constellation NewEnergy, Inc., Constellation Generation Group, LLC, Reliant Energy, Inc., Mirant California, LLC, Mirant Delta, LLC, Mirant*

III. Conclusion.

As was demonstrated at the PA Workshop, portfolio analysis can be a powerful tool for understanding and measuring risks associated with investment decisions, especially when those investment decisions are constrained by specific reliability and environmental goals. However, trying to develop a better or more comprehensive models to drive investment decisions undertaken through regulatory intervention will addresses only half the "battle" in lowering consumers' energy costs, because as was often repeated at the PA Workshop "we don't know what we don't know." The other half of the battle needed to reduce consumers' costs lies in actively managing investment risks, a task for which the current utility investment paradigm, with its focus on rate-based return on investment and consumer cost pass throughs, is not well-suited. Refocusing on measures that will re-invigorate the merchant investment model will drive the development of efficient frontier portfolios that meet the public policy goals where the risks associated with those portfolios are borne by the investors, rather than by ratepayers.

There are many promising signs that competitive wholesale and retail markets are gaining strength in California: the CAISO's deployment of MRTU; the CPUC's implementation of resource adequacy requirements and capacity markets; potential reforms to utility procurement practices to remedy the flaws in the hybrid market structure; the implementation of real-time metering that coupled with scarcity pricing provides for meaningful demand response; and the newly initiated investigation by the CPUC of the

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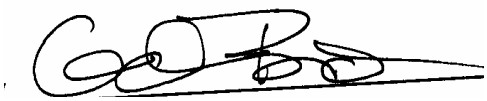
Potrero, LLC, (Collectively, "Competitive Market Advocates"), March 2, 2007, submitted in CPUC Docket R.06-02-013.

reopening of direct access markets. As the CEC continues its analysis and investigation of tools that can improve how California's energy needs will be reliably met consistent with our aggressive environmental goals, Constellation and Mirant urge that the CEC carefully consider how these tools will be used to avoid hindering the emerging competitive wholesale and retail markets.

June 12, 2007



Mary Lynch
Vice President, Regulatory and Legislative Affairs

Constellation Energy Group, Inc.
2377 Gold Meadow Way, Suite 100
Gold River, CA 95670
Phone: (916) 526-2860
Fax: (916) 606-0783
Email: Mary.Lynch@constellation.com

Andrew B. Brown

Ellison Schneider & Harris L.L.P.
2015 H Street
Sacramento, CA 95814
Phone: (916) 447-2166
Fax: (916) 447-3512
Email: abb@eslawfirm.com

Attorneys for Constellation Energy Commodities Group, Inc., and Constellation NewEnergy, Inc.